PUBLIC PENSION OVERSIGHT BOARD

Minutes of the 3rd Meeting
of the 2020 Interim

July 28, 2020

Call to Order and Roll Call

The 3rd meeting of the Public Pension Oversight Board was held on Tuesday, July 28, 2020, at 1:00 PM, in Room 171 of the Capitol Annex. Representative Jim DuPlessis, Chair, called the meeting to order, and the secretary called the roll.

Present were:

Members: Senator Jimmy Higdon, Co-Chair; Representative Jim DuPlessis, Co-Chair; Senators Christian McDaniel, Gerald A. Neal, Dennis Parrett, Wil Schroder, and Mike Wilson; Representatives Joe Graviss, Jerry T. Miller, Phillip Pratt, Steven Rudy, Russell Webber, and Buddy Wheatley; John Chilton, Mike Harmon, John Hicks, James M. "Mac" Jefferson, and Sharon Mattingly.

Guests: David Eager, Executive Director, Rebecca Adkins, Executive Director Office of Operations, and Kathy Rupinen, Interim Executive Director of Legal Services, Kentucky Retirement Systems; Bryanna Carroll, Director of Governmental Affairs, Kentucky League of Cities; and Bo Cracraft, Legislative Research Commission.

LRC Staff: Brad Gross, Bo Cracraft, and Katie Carney

Approval of Minutes

Representative Graviss moved that the minutes of the June 1, 2020 meeting be approved. Representative Rudy seconded the motion, and the minutes were approved without objection.

County Employees Retirement System Separation Update (HB 484)

David Eager, Kentucky Retirement Systems (KRS), began his presentation by stating that KRS had formed a task force of six staff members, who had worked collectively to analyze HB 484 and how it would be implemented. He noted the size and complexity of the bill and stated that staff currently had a spreadsheet with over 96 different items, which included several to-do tasks, clarifications, policy developments, or a variety of other issues associated with the bill. Mr. Eager stated the process has highlighted several key policy issues that he would be outlining during the presentation.

Mr. Eager first summarized the three retirement boards that were established with passage of HB 484. He stated that HB 484 was taking KRS from one board to three boards, which included a 9-member board to administer the Kentucky Employees Retirement System (KERS) and the State Police Retirement System (SPRS), a 9-member board to administer the County Employees Retirement System (CERS), and an 8-member board, known as the Kentucky Public Pension Authority (KPPA), that will administer day to day operations of all underlying plans. He noted that all current KRS staff members would become KPPA staff members, and employees would remain subject to KRS Chapter 18A and the state Personnel Cabinet.

Mr. Eager began to discuss several policy issues. First, he noted the effective date of the new structure is set for April 1, 2021, but that it would begin without a board, CEO, bylaws, and policies. He asked if appropriate legislation could be passed to establish the boards prior to April 1, 2021, but have any action made effective April 1, 2021. He noted the amount of tasks that will need to be completed and explained that early appointments to the boards would allow for a more effective transition.

In response to a question from Representative Graviss regarding KRS' recommendation, Mr. Eager stated staff would like legislation that would establish the authority of the boards. Kathy Rupinen, KRS, also stated the current legislation does have language that allows the KRS Board to make administrative decisions that will stay in effect until KPPA or CERS acts on them. However, due to the significance of the decisions being made, KRS feels it would be more efficient if KPPA and CERS could begin functioning prior to April 1, 2021. In response to a follow-up question, Mr. Eager stated that KRS has met with Representative Webber to discuss the need for a housekeeping bill. Representative Webber confirmed that he is working with KRS on legislation and will report to Public Pension Oversight Board (PPOB) with a proposal.

Representative DuPlessis noted that Co-Chair Higdon and Mr. Hicks were present remotely.

Representative DuPlessis commented that under the current legislation, the Governor will make the appointments to the KPPA and CERS boards, but they would not have any power until April 1, 2021. Ms. Rupinen agreed and stated the action KRS is requesting for the KPPA and CERS boards would allow them to convene as boards and make decisions before April 1, 2021, but that any decisions would not be effective until April 1, 2021.

In response to a question from Representative Miller with regards to policies and practices, Ms. Rupinen stated that it is possible that each board could pass their own different or divergent policies, but believes staff's initial recommendation will be similar. But given each board will have their own fiduciary duties, it is possible that policies could change and diverge over time. Representative Miller stated that he understands that things such as investments could differ, but clarified that the intent of HB 484 was to not duplicate overhead. Ms. Rupinen stated that a lot of the day-to-day operations will be under the KPPA.

Secondly, Ms. Rupinen discussed policy issues relating to leadership positions and stated that it is KRS' belief that excluding all three boards from personnel contracting provisions of KRS Chapter 45A, the Model Procurement Act, would be in the best interest of all. At a minimum, she suggested that providing an exemption for retaining the executive director of KRS for the KPPA, on at least a temporary basis, would be prudent, given the short timeframe, cost to produce requests for proposals (RFPs), and concern that qualified applicants might not participate. She stated that HB 484 currently provides an exception for the hiring of the CEO for CERS, so staff would suggest the same exception to be applied to KPPA and KRS.

In response to a question from Representative DuPlessis regarding the RFP process, Mr. Eager stated that he would suggest each of the boards be exempted, so they could recruit, hire, and appoint the executive director and CEOs without having to go through the RFP process.

Third, Ms. Rupinen discussed the current 8-member KPPA board and the lack of any mechanism to break ties that might occur given the current board composition. She stated that KRS has suggested the KPPA executive director could act as the tie breaker, but staff were up for other suggestions.

Representative Rudy stated that he did not believe there was a need to give one person the power on the deciding vote. He referenced the even number of House and Senate seats and believes that equal balance will force the members to work together and come to decisions. He stated he would not support this request.

Representative DuPlessis, Representative Graviss, and Senator Higdon commented that they also agree with Representative Rudy's comment.

Next, Mr. Eager began to discuss a couple of questions that staff have with regards to intent or just clarification. He began by highlighting a situation that will result with regards to the newly formed KRS board, where 10 current members will be left to fill only 9 positions on the new board. He stated that KRS needs some direction on how to determine what individuals fill the 9 positions. Ms. Rupinen stated the legislation specifically states that the Governor appointee will cease serving on the KERS board and the other 6 Governor appointees are ones who were deemed to have the appropriate investment experience. The concern is none of the Governor appointees' orders specify who is deemed knowledgeable about the impact of pension requirements on local governments. She stated that KRS has requested an Attorney General's opinion.

Mr. Eager continued with the question of whether or not the CEOs for the KRS and CERS boards are required to be attorneys. Ms. Rupinen added the legislation currently states that the CEOs must provide legal counsel to their boards, so that is where the confusion arises. She stated that KRS is in the process of drafting a request for an opinion from the Kentucky Bar Association.

Representative DuPlessis announced that Senator Parrett is also in agreement that the KPPA board remain with 8 members.

Mr. Eager finished with a suggestion from KRS that the current executive director for KRS serve as the KPPA executive director until that appointment is filled. Ms. Rupinen added that the current contract, as it exists, is for an executive director of KRS, but as of April 1, there will no longer be executive director of KRS.

Representative Rudy commented that he believes these actions can take place at an 8:00 a.m. April 1, 2021 meeting. Mr. Eager responded that if a board is not appointed before April 1, 2021 there will be no one to meet on that date. Ms. Rupinen added that KRS is an administrative agency and can only act purely within what the statute allows, plus there is a fiduciary duty in regards to expenses of the systems.

In response to a question from Representative Graviss regarding whether or not Mr. Eager's executive director status with KRS would continue if he moved into the executive director status of KPPA, Ms. Rupinen stated that if the statute has been correctly interpreted and the CEO of KRS has to be an attorney, Mr. Eager's contract could not fulfill the role for KRS. He could serve as KPPA executive director. In response to a follow-up question, Ms. Rupinen stated that KRS has been in contact with staff of the Finance Cabinet and they have indicated that modifications can be made. Ms. Rupinen stated that KRS needs clarification from the PPOB.

Representative Miller commented that he agrees that there needs to be a housekeeping bill and probably an emergency clause effective March 2021. He added that his intentions was not for the CEOs to be attorneys.

Representative DuPlessis commented that he also did not intend for the CEOs to be attorneys.

Senator Higdon commented that he is passionate on keeping the KRS Chapter 45A contracting status in place.

Representative DuPlessis commented that he believes there is a way to accomplish these tasks and keep the transparency.

In response to a question from Representative Rudy, Ms. Rupinen stated that Mr. Eager's current contract expires June 30, 2021, which is subject to approval by the boards and his current position as executive director of KRS no longer exists as of April 1, 2021.

Representative Webber commented that HB 484 was a comprehensive and large legislative change. He also noted that on page 1 of HB 484, language stated that during the 2021 regular session legislation separate statutory structures would be created. New issues that were discussed today could be incorporated and addressed. He stated that he is going to work with KRS to come up with legislation that addresses the housekeeping issues.

Representative Miller commented that any new contracts need to reflect the 2017 provisions in SB 2. He also stated that he would like to know what KRS' progress is on posting unredacted contracts on the website. Mr. Eager stated he would address the unredacted contract issue at the next investment related meeting of PPOB.

Rebecca Adkins, KRS, finished by discussing a summary of several administrative tasks KRS is working through with regards to the separation. She noted that the issues included financial changes, legal issues, establishing a new state agency, creation of boards, publications/print media, communications, and benefit processing changes.

In response to a questions from Senator McDaniel regarding a benefit process task noted on the slide, Ms. Adkins stated that task was related to a circuit clerk transfer, of which KRS has not done many and which was a reasonable removal from the legislation. She stated that it is her understanding that it is a CERS transfer where circuit clerks can choose under certain circumstances to be in KERS. Representative DuPlessis commented that, per LRC staff, circuit clerks transferred in 1996 from KERS to CERS.

Bryanna Carroll, Kentucky League of Cities (KLC), stated that KLC anticipated that the effective date could cause some problems and questions and does not have any issues with legislators making changes to expedite the boards coming into place. She believes that KLC can work with the Governor to make sure their appointments are made prior to April 1, 2021. In regards to KRS Chapter 45A, KLC is going to request that CERS be added back under the chapter for the procurement process of the CEO position. She stated that KLC agrees that the KPPA should remain an 8-member board. Ms. Carroll stated that KLC has no position regarding who is selected for the KRS 9 member board seats. She stated that KLC, Kentucky Association of Counties, and the Kentucky School Board Association are all in agreement that the CERS staff position needs to be an attorney.

In response to a question from Representative DuPlessis regarding why KLC felt the CEO position needed to be an attorney rather than using contracted counsel representation, Ms. Carroll stated that the language provided in the bill states that the board can hire one staff member, but believes it could possibly contract counsel.

Lastly, Ms. Carroll commented that KLC has no issues with the KRS executive director serving as the KPPA executive director until the KPPA decides on a contract to fill that position.

2020 Study Topic Overview of Pension UAL Financing Methods

Bo Cracraft, LRC Staff, noted his presentation was the result of an administrative recommendation adopted in the 2019 PPOB annual report. The goal was to review and discuss how plans within and outside Kentucky finance pension unfunded accrued liability (UAL). He began with a quick summary of the actuarial valuation process and the various inputs and outputs that are incorporated. He stated that the key inputs are refined over time with periodic studies and audits, while the key outputs include information on plan health and employer contribution rates.

Next, Mr. Cracraft discussed a plan's actuarial required contribution rate (ARC), and how it was the result of two underlying building blocks. First, a plan has a normal cost, which represents the cost for that year's benefit accrual. Secondly, you have an annual amortized UAL payment, which is the plan's portion of a larger UAL debt. He discussed how a plan's UAL is impacted by several factors, including actual experience, assumption changes, or other input changes. He noted that in many cases, plans have had to deal with unfavorable outcomes, which has led to growth in UAL.

Plans must develop a structure to finance or pay down their UAL. Mr. Cracraft identified four key components, which included: amortization period, closed or open (is period fixed, variable, or rolling), single or separate (by year, source, or both) amortization bases, and method (level percent of payroll or level dollar). Other factors considered included a plan's interest rate, a possibility of negative amortization, and statutory requirements.

Mr. Cracraft began by discussing the amortization period component. He stated that, historically, most plans have used 30 years, but added that a lot of times with pensions, a rolling period was used. He stated that both of the state's larger plans had utilized 30-year windows in the past and referenced a recent study by the Society of Actuaries that reported that roughly 3 out of 4 plans amortized UALs over a window of 20 to 30 years. Lastly, he commented that recent evidence is pointing to more plans moving to shorter, 20-year periods, at least for some of their UAL and that actuaries and the Government Finance Officers Association were now recommending shorter periods.

Next, once the length is determined, choosing an open or closed period was the next decision to be made. Mr. Cracraft stated that historically most plans used open periods and both of Kentucky's two largest plans were on open windows until 2007 for KRS and 2013 for Teachers' Retirement System (TRS). He noted that using an open window prolongs the payback period, sometimes indefinitely, and is more likely to lead to negative amortization, so, many plans have more recently moved to closed windows. According to a 2019

National Conference on Public Employee Retirement Systems' study, 2 out of 3 plans were using a closed period, while a LRC staff review of 50 larger state plans studied resulted in 3 out of 4 using a closed period.

Third, Mr. Cracraft discussed the use of single and separate amortization base. Under a single base approach, a plan has a single amortization base or layer, which ends on a specific date. Any increase or decrease in UAL during the closed period is then re-amortized over the remaining period in each valuation. KRS historically used a single closed base, until recent legislation was passed. One drawback to a closed period is that it can introduce some volatility in the final years, especially if a plan experiences a significant change in their UAL, which would need to be amortized over a shorter period. As a result, many plans have moved to using separate bases or layers, with an increase or decrease in UAL from a given year or source being amortized individually. Annual payments for each base or layer are added together for total UAL payment. He noted TRS had been using a layered approach since 2014 and that KRS was moving too for their 2020 valuation. Mr. Cracraft shared two examples, using the historical KRS single layer model and current TRS layered approach.

In response to a question from Representative DuPlessis regarding an additional cost of a layered approach, Mr. Cracraft responded that he did not believe a layered approach should increase costs to administer. He did state the calculation process is a bit more complicated, thus actuaries might charge slightly more, but that it should be minimal.

Lastly, the final decision point is the method of financing the UAL, which for most plans is either level percent of payroll or level dollar. Level percent assumes a payment that is based on a fixed percent of a growing payroll, while level dollar is much more like a traditional home mortgage with flat payments across the entire time period. He stated that most plans in the pension industry use level percent of payroll, referencing the LRC staff review that found 37 out of 50 plans using level percent of payroll. He noted that in Kentucky, statute requires a level percent for KERS and CERS, while the TRS board had chosen to use level percent of pay. The KRS board had adopted a 0 percent payroll growth for KERS, which made it a level dollar payment, while CERS assumed 2.0 percent payroll growth. The TRS board has adopted a 3.5 percent payroll growth assumption.

Mr. Cracraft provided and quickly reviewed a slide comparing the policies for each of the three systems that the state administers. He noted that some plans, such as KRS and the Judicial Form Retirement System (JFRS), had the majority of their funding policy outlined by statute, while TRS was largely developed by board policy.

Lastly, Mr. Cracraft provided information on several local or state plans that had made recent changes to their policies, such as, Tennessee, Indiana, Missouri, Alaska, Kansas, and Colorado. He noted many of the trends discussed, such as closed windows, layering, and shorter amortization periods were evident.

In closing, Mr. Cracraft summarized the key takeaways from staff's review. He commented that new amortization periods are definitely shortening, but with legacy liabilities generally amortized over 30-year windows, closed periods are becoming the norm, and more plans are moving to separate amortization bases, primarily by year. He stated that level percent of pay is still the norm, but there has been a recent trickle of plans moving to level dollar. TRS and KRS have largely followed trends. Lastly, KRS and JFRS plans largely operate by statutory language, while TRS is operated largely by board policy/decisions.

In response to a question from Representative Wheatley regarding how the Kentucky plans might avoid a future cliff or significant drop off in contributions, Mr. Cracraft stated moving to a layered approach as it stands now for KERS and TRS will not remove the cliff given the overwhelming majority of the existing UAL for both plans are being amortized over a single base. He commented that in order to reduce or remove the cliff, the legacy UAL for both plans would have to be adjusted to separate layers or tranches, where in 10-15 years you would start to see a portion of each year retired.

Representative DuPlessis commented regarding funding the UAL, he would like to have more discussions about breaking it up amongst the entities that actually pay what they owe instead of having a broad number that covers everyone.

With no further business, the meeting was adjourned.